

# ENTREPRENEURIAL ACTIVITIES IN EUROPE

## INFORMAL ENTREPRENEURSHIP

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# Policy Brief on Informal Entrepreneurship

Entrepreneurial Activities in Europe



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# **Policy Brief on Informal Entrepreneurship**

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## KEY MESSAGES

- Despite a slow decline in the last 10 years, the informal economy in the EU has proved resilient. This is especially true in the Eastern and Southern Member States, where it often accounts for more than 20% of the national GDP.
- Informal entrepreneurship – i.e. informal self-employment and informal new entrepreneurs – is a major component of the informal economy as a whole. Informal self-employment as the main source of income is most common in Southern Europe, while informal self-employment covering small occasional activities (i.e. paid favours) is most common in Nordic countries. On the other hand, informal start-up rates are higher in Eastern and Southern Europe, although exceptions exist. Men, youth, the unemployed, the self-employed and rural dwellers are more likely than other social groups to engage in informal self-employment.
- The level of informal entrepreneurship is affected by macroeconomic conditions. Periods of economic expansion are associated with ebbing informality, whereas moments of economic slowdown lead to growing informality. Institutional factors also matter for advanced economies such as those of the EU. High taxation, burdensome business regulations and lack of deterrence are all found to be important drivers of informality.
- Formalisation strategies will hinge on three policy pillars: deterrence, incentives and persuasion. While the first two approaches try to alter the cost-benefit ratio for entrepreneurs to stay in the informal sector, the third seeks to win their “hearts and minds” by fostering a culture of compliance.
- Deterrence measures are the most commonly used to tackle the informal economy as a whole. However, they may be ill-suited to spotting informal entrepreneurship, since labour inspections are focused on registered businesses and often start from a worker’s complaint against the employer. As a result, incentives will play a more important role in coping with informal entrepreneurship. These can either target the entrepreneurs (e.g. supply-side incentives) or the consumers who source products and services in the informal sector (demand-side incentives). On the supply side, incentives will include tax breaks and welfare bridges that facilitate the welfare-to-work transition of informal entrepreneurs, while on the demand side sector-based tax deductions, vouchers and VAT exceptions are the most common incentives.
- Persuasion measures can be an important complement to the traditional policy of “sticks & carrots”. In particular, they can be useful for social groups disadvantaged in the labour market (e.g. ethnic minorities, low-educated, residents of deprived neighbourhoods) where participation in informal entrepreneurship is the result of multiple forms of deprivation (e.g. cultural barriers and lack of skills) which deterrence and fiscal incentives alone are unlikely to solve.

## ■ INTRODUCTION

The informal economy has proven an enduring problem in the developing world as much as in advanced economies such as those of the European Union. Since the 1970s, the process of industrial downsizing and outsourcing has renewed the importance of small firms, which are more likely than large companies to conceal part of their activities to state authorities. Meanwhile, EU economies have become more and more regulated, which has raised the costs of starting and managing a business and driven more firms and workers towards the informal sector.

Own-account workers and new entrepreneurs account for a large proportion of the people employed in the informal sector (Williams et al., 2012; Hazans, 2011). The self-employed, especially those engaged in personal and household services (e.g. home maintenance and personal caring), are those who can more easily evade the income tax and value added tax (VAT). On the other hand, new entrepreneurs may decide to start up in the informal sector to test their business idea first at a lower cost than if they had to fully comply with the law.

This policy brief focuses on the informal self-employed and informal new entrepreneurs, which together comprise what we define as

“informal entrepreneurship”. Consistent with a commonly used definition of the informal economy, this is here referred to as “the sector of the economy where transactions concern legal activities and are money-based, but are not declared for tax, benefit and labour law purposes when they should be declared”. It follows that informal entrepreneurship includes “self-employed people and new business owners who are engaged in legal activities for which they receive a payment which is not declared, partly or fully, for tax, benefit and labour law purposes when it should be declared”.

The policy brief proceeds as follows. First, estimates on the size of the informal economy and informal entrepreneurship in the EU are given which show that both are significant, especially in certain countries and among certain social groups. Second, the main causes of informal entrepreneurship are investigated. Third, it is shown that the main impacts of informal entrepreneurship on the economy are negative, which warrants policy intervention at the EU level. Fourth, a conceptual framework for formalisation strategies is presented which hinges on the distinction between deterrence, incentive and persuasion policies. Finally, the conclusions summarise the main policy messages.

## ■ THE SIZE OF THE INFORMAL ECONOMY AND INFORMAL ENTREPRENEURSHIP IN THE EU

Measuring the informal economy is an elusive quest, as the main purpose of those who work in the informal sector is to “fly under the radar” of public authorities. Nonetheless, estimates on the size of the informal economy and of informal entrepreneurship are available, although they need to be taken with some caution.<sup>(1)</sup>

Based on the most commonly referred econometric estimates, the size of the informal economy in the EU ranges from less than 8% in Austria to nearly 32% of the national GDP in Bulgaria, with the EU-27 simple average standing at 18.4% (Schneider, undated).

**Table 1. The size of the informal economy in the EU-27, 2003-2012**

As a percentage of national GDP



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Austria	10.8	11	10.3	9.7	9.4	8.1	8.5	8.2	7.9	7.6
Belgium	21.4	20.7	20.1	19.2	18.3	17.5	17.8	17.4	17.1	16.8
Bulgaria	35.9	35.3	34.4	34	32.7	32.1	32.5	32.6	32.3	31.9
Cyprus	28.7	28.3	28.1	27.9	26.5	26	26.5	26.2	26	25.6
Czech Republic	19.5	19.1	18.5	18.1	17	16.6	16.9	16.7	16.4	16
Denmark	17.4	17.1	16.5	15.4	14.8	13.9	14.3	14	13.8	13.4
Estonia	30.7	30.8	30.2	29.6	29.5	29	29.6	29.3	28.6	28.2
EU-27 (simple average)	22.3	21.9	21.5	20.8	19.9	19.3	19.8	19.5	19.2	18.4
Finland	17.6	17.2	16.6	15.3	14.5	13.8	14.2	14	13.7	13.3
France	14.7	14.3	13.8	12.4	11.8	11.1	11.6	11.3	11	10.8
Germany	17.1	16.1	15.4	15	14.7	14.2	14.6	13.9	13.7	13.3
Greece	28.2	28.1	27.6	26.2	25.1	24.3	25	25.4	24.3	24
Hungary	25	24.7	24.5	24.4	23.7	23	23.5	23.3	22.8	22.5
Ireland	15.4	15.2	14.8	13.4	12.7	12.2	13.1	13	12.8	12.7
Italy	26.1	25.2	24.4	23.2	22.3	21.4	22	21.8	21.2	21.6
Latvia	30.4	30	29.5	29	27.5	26.5	27.1	27.3	26.5	26.1
Lithuania	32	31.7	31.1	30.6	29.7	29.1	29.6	29.7	29	28.5
Luxembourg	9.8	9.8	9.9	10	9.4	8.5	8.8	8.4	8.2	8.2
Malta	26.7	26.7	26.9	27.2	26.4	25.8	25.9	26	25.8	25.3
Netherlands	12.7	12.5	12	10.9	10.1	9.6	10.2	10	9.8	9.5
Poland	27.7	27.4	27.1	26.8	26	25.3	25.9	25.4	25	24.4
Portugal	22.2	21.7	21.2	20.1	19.2	18.7	19.5	19.2	19.4	19.4
Romania	33.6	32.5	32.2	31.4	30.2	29.4	29.4	29.8	29.6	29.1
Slovakia	18.4	18.2	17.6	17.3	16.8	16	16.8	16.4	16	15.5
Slovenia	26.7	26.5	26	25.8	24.7	24	24.6	24.3	24.1	23.6
Spain	22.2	21.9	21.3	20.2	19.3	18.4	19.5	19.4	19.2	19.2
Sweden	18.6	18.1	17.5	16.2	15.6	14.9	15.4	15	14.7	14.3
United Kingdom	12.2	12.3	12	11.1	10.6	10.1	10.9	10.7	10.5	10.1

Source: Schneider F. (undated), “Size and Development of the Shadow Economy of 31 European and 5 other OECD Countries from 2003 to 2012: Some New Facts”, [http://www.econ.jku.at/members/Schneider/files/publications/2013/ShadEcEurope31\\_Jan2013.pdf](http://www.econ.jku.at/members/Schneider/files/publications/2013/ShadEcEurope31_Jan2013.pdf)

<sup>(1)</sup> Most attempts at measuring the informal economy are based on econometric models (e.g. the currency demand and electricity consumption approaches) that rely on strong assumptions – for example, that all transactions in the informal economy are carried out in cash in the case of the currency demand approach – and that accordingly tend to generate large estimates. Examples of this include estimates by Prof. Schneider (see Chapter 4 of European Commission, 2013b). Another methodology commonly used has been surveys (e.g. the Eurobarometer Survey on Undeclared Work EC, 2013a), which are also flawed to the extent that they generate figures often too low due to the reluctance of the interviewees to admit any involvement in the informal economy.

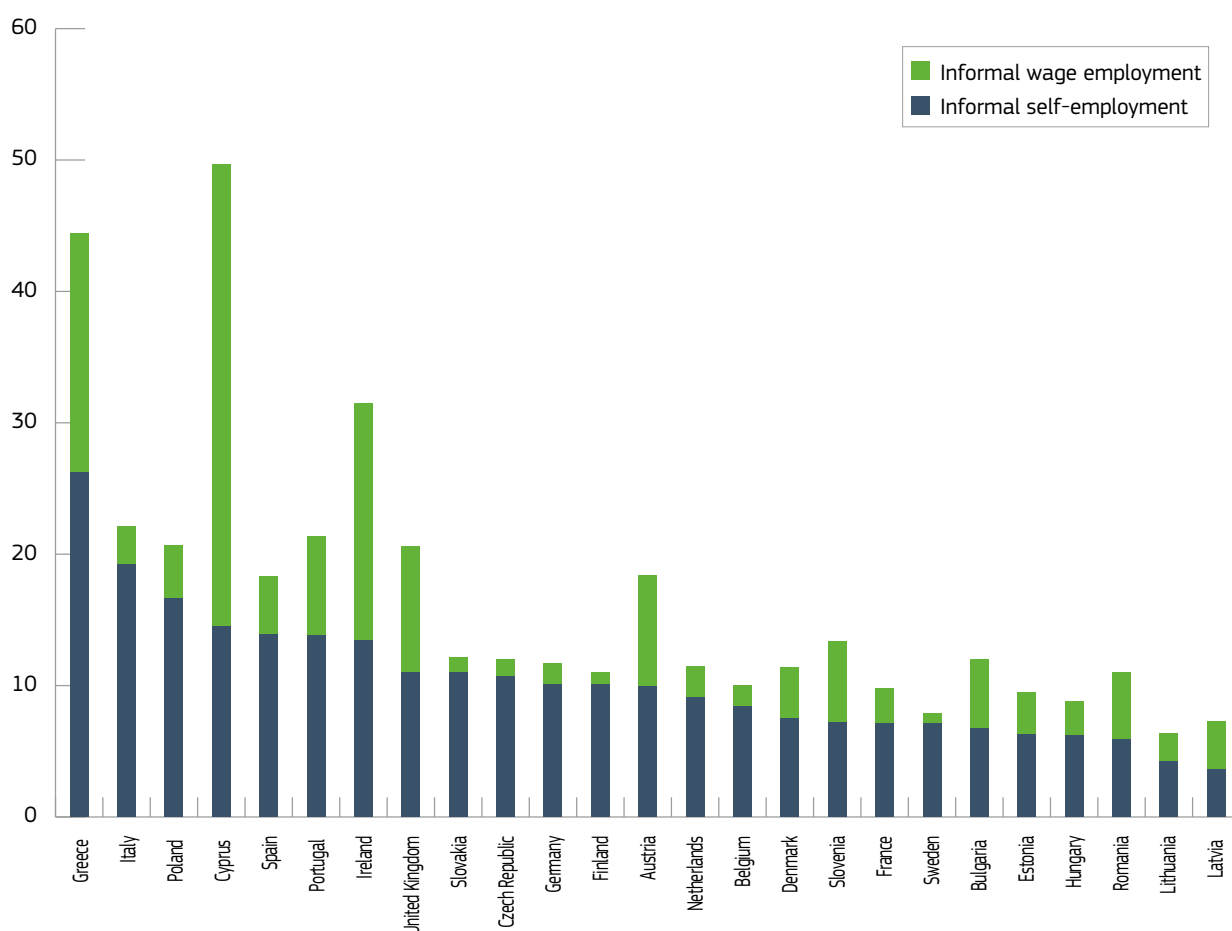
Two clear blocks emerge from Table 1. Eastern and Southern European countries have typically rates above the EU average, with the exceptions of the Czech Republic and the Slovak Republic, while Western European and Nordic countries have lower-than-average rates.<sup>(2)</sup> In the last ten years, the informal economy in relation to GDP has contracted in the whole EU, with progress also made by countries where the informal economy has traditionally been large (e.g. Italy, Greece, Romania, Latvia and Bulgaria). A possible reason behind this contraction has been the period of economic growth that involved most of the EU until 2008, when the global crisis led to a renewed but short-lived expansion of the informal economy.

Evidence on informal entrepreneurship is less available than on the informal economy as a whole. Some recent estimates point to higher rates of informal self-employment in Southern Europe, while the differences between Western and Eastern Europe are subtler than for the underground economy as a whole (Hazans, 2011) (Fig. 1).<sup>(3)</sup> In fact, with the exceptions of Poland and the Slovak Republic, informal self-employment rates are slightly higher in Western and Northern European countries than in Eastern European countries. More generally, informal self-employment is more prevalent than informal wage employment across all EU Member States covered by the analysis, except for Cyprus and Latvia.

**Figure 1. Informal self-employment and informal wage employment rates**



Percentage of the active labour force



Source: Hazans (2011), "Informal Workers across Europe: Evidence from 30 Countries", IZA Discussion Paper No. 5871, Institute for the Study of Labor, Bonn.

Eurobarometer has also collected survey evidence on undeclared work in 2007 and 2013 (EC, 2007a; EC, 2014a), although information on informal self-employment is only available through a re-elaboration of the data from the first of the two

surveys (Williams et al., 2012). These surveys underestimate the size of the problem because they rely on the willingness of the interviewees to avow having worked or having sourced work in the informal economy. Yet, they have the merit of

(2) Eastern European countries include Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and the Slovak Republic. Western European countries include Austria, Belgium, France, Germany, Ireland, Luxembourg, Netherlands and United Kingdom. Southern European countries include Cyprus, Greece, Italy, Malta, Portugal and Spain. Nordic countries are Denmark, Finland and Sweden.

(3) This study was based on the European Social Survey, where a question asked respondents whether they were working and whether they had currently a labour contract. Informal dependent employment was considered the one carried out for an employer but without any contract, while informal self-employment was defined to include all non-professional self-employed operating on their own as well as employers with five or fewer workers.



confirming that informal self-employment is a major component of undeclared work.

According to the 2007 Eurobarometer survey, only 5% of the surveyed population admits to having been actively involved in the informal sector. Of this 5% three-quarters (i.e. 77%) have done so in the position of self-employed; this corresponds to nearly 4% of the overall surveyed population. Data on participation rates in informal self-employment across EU macro-regions generate unexpected results: 9% of the total population in Nordic countries state having provided informal self-employed work (88% of all undeclared work), while the rates are 4% in Eastern Europe (67% of all undeclared work), 3% in Western Europe (63% of all undeclared work) and 2% in Southern Europe (76% of all undeclared work).<sup>(4)</sup> Nearly three-quarters of the informal self-employed (73%) have offered their services to neighbours, family and friends – which are

accordingly defined as “paid favours” – while slightly more than one-quarter (27%) have worked for previously unknown people. Paid favours are most common in Nordic countries and Western Europe and least common in Eastern and Southern Europe.

Sector-wise, informal self-employment is most common in the household services sector (e.g. cleaning services and care for children and the elderly) (25% of total informal self-employment), the construction industry (19%) and the personal services sector (e.g. hairdressing) (11%), while from a socio-demographic viewpoint the most involved are men, youth, students, the unemployed, the self-employed and those living in rural areas. Most of these groups (e.g. men, youth, and rural dwellers) mainly undertake “paid favours”. Interestingly, women make less money out of their informal self-employment activities than men, which reflects traditional gender discrimination in the formal labour market (Williams et al., 2012; EC, 2007a).

Table 2. Informal self-employment in the EU-27 by region and socio-demographic groups, 2007



	Percentage of engaged into informal self-employment	Percentage of all informal self-employment surveyed	Percentage of surveyed population	Average total hours	Average hourly informal earnings (EUR)	Mean total annual informal earnings (EUR)	Percentage of informal self-employment conducted for:	
							Closer social relations (paid favours)	Other private persons/ households
EU-27	4	100	100	73	11.05	806	73	27
<b>EU region</b>								
Nordic	9	11	4	39	13.85	536	84	16
Western	3	49	48	58	12.78	742	83	17
Eastern	4	24	22	90	7.48	673	64	36
Southern	2	16	26	133	7.58	1006	53	47
<b>Gender</b>								
Men	4	63	48	75	11.71	878	79	21
Women	2	37	52	69	8.13	561	64	36
<b>Age</b>								
15-24	6	30	15	76	9.61	736	75	25
25-39	5	43	26	58	12.01	700	58	42
40-54	3	24	26	68	11.25	769	71	29
55+	<1	3	33	69	8.5	591	0	100
<b>Employment status</b>								
Self-employed	6	12	7	34	17.39	582	72	28
Managers	2	7	10	49	12.25	605	88	12
Other white collars	3	9	12	55	9.47	521	83	17
Manual workers	4	29	22	74	11.71	870	75	25
House persons	2	6	9	115	10.2	1176	71	29
Unemployed	6	11	6	92	7.59	718	62	38
Retired	1	8	25	66	7.84	522	74	26
Students	6	18	10	66	8.84	585	69	31
<b>Urban/rural areas</b>								
Rural area	4	40	32	79	10.4	822	80	20
Small/medium town	3	40	42	68	10.72	732	68	32
Large urban area	3	20	26	61	11.28	693	71	29

Source: Williams C., S. Nadin and J. Windebank (2012), “Evaluating the prevalence and nature of self-employment in the informal economy: Evidence from a 27-nation European survey”, *European Spatial Research and Policy*, Vol. 19, N.1.

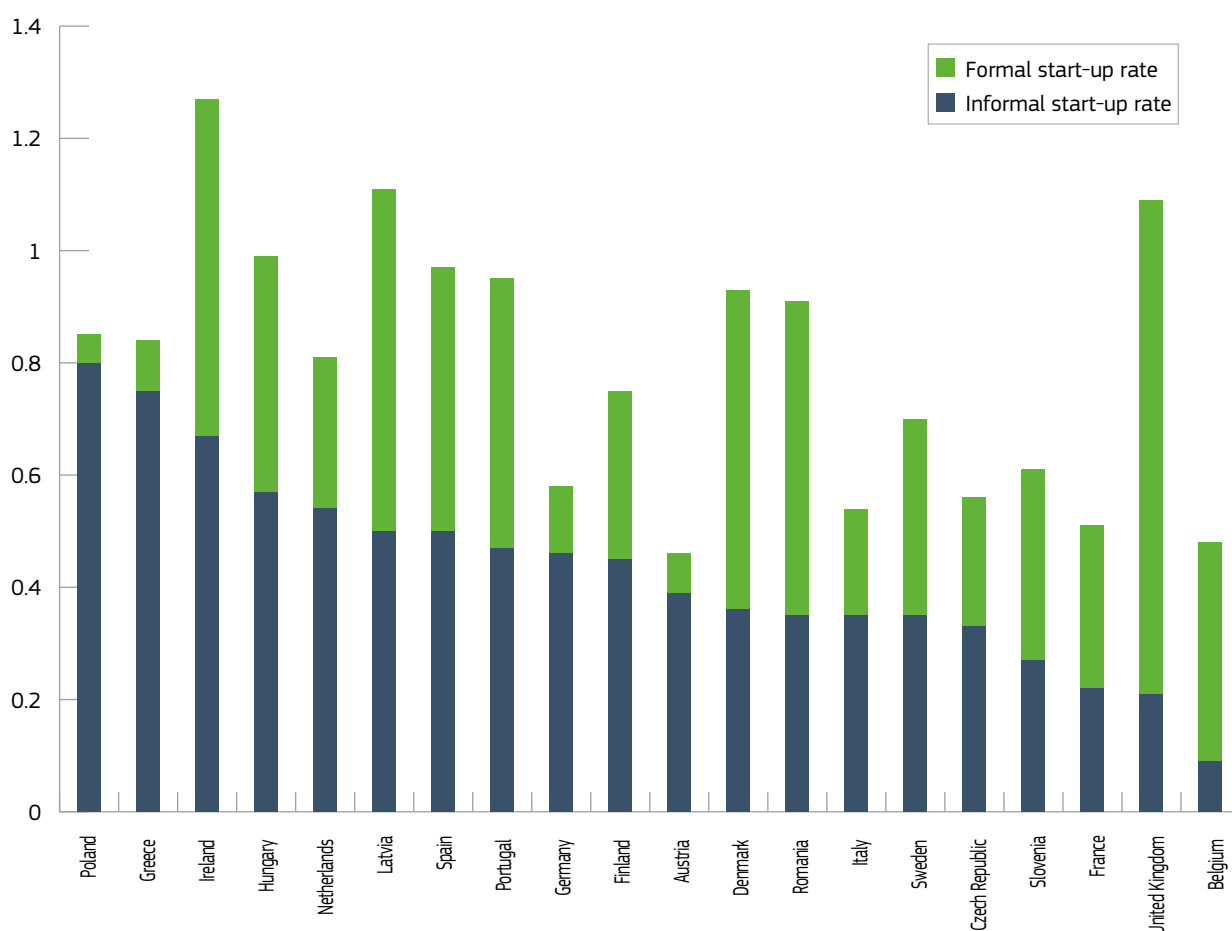
(4) Eurobarometer applies the following classification for EU countries. Nordic countries include Denmark, Finland and Sweden; Eastern and Central Europe encloses Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, the Slovak Republic and Croatia; Continental Europe includes Belgium, Germany, France, Ireland, Luxembourg, the Netherlands, Austria and the United Kingdom; Southern Europe refers to Cyprus, Greece, Spain, Italy, Malta and Portugal. In this policy brief, the group of Eastern and Central Europe has been renamed “Eastern Europe”, while Continental Europe has been renamed “Western Europe”.

On the whole, Table 2 suggests that Eurobarometer mainly covers informal self-employment of voluntary and occasional type. Informal self-employment as the main source of income is missed by the survey, as shown by the statistics on gross earned income and hourly wage rates and by the fact that Southern European nations seem less affected by informality than Western or Nordic countries, against most existing evidence. One reason might be that where informality is widespread and the main source of livelihood, interviewees are more reluctant to declare their involvement.

Informal entrepreneurship also refers to informal start-up rates, i.e. the proportion of people who start a business in the informal sector rather than in the formal sector. A recent estimate of informal and formal start-up rates in 20 EU countries shows the highest informal start-up rates in Poland, Greece and Ireland (Autio and Fu, 2014) (Figure 2). In Poland, for every formal new entrepreneur there are sixteen that do not register their business, whereas in Greece the same ratio is eight to one. However, high informal-to-formal start-up ratios are also found in Austria (5.6) and Germany (3.8), which are otherwise nations considered to host small informal sectors.<sup>(5)</sup>

Figure 2. Informal and formal start-up rates in 20 EU countries, 2001-2010

Number of new businesses per 100 adult-age population



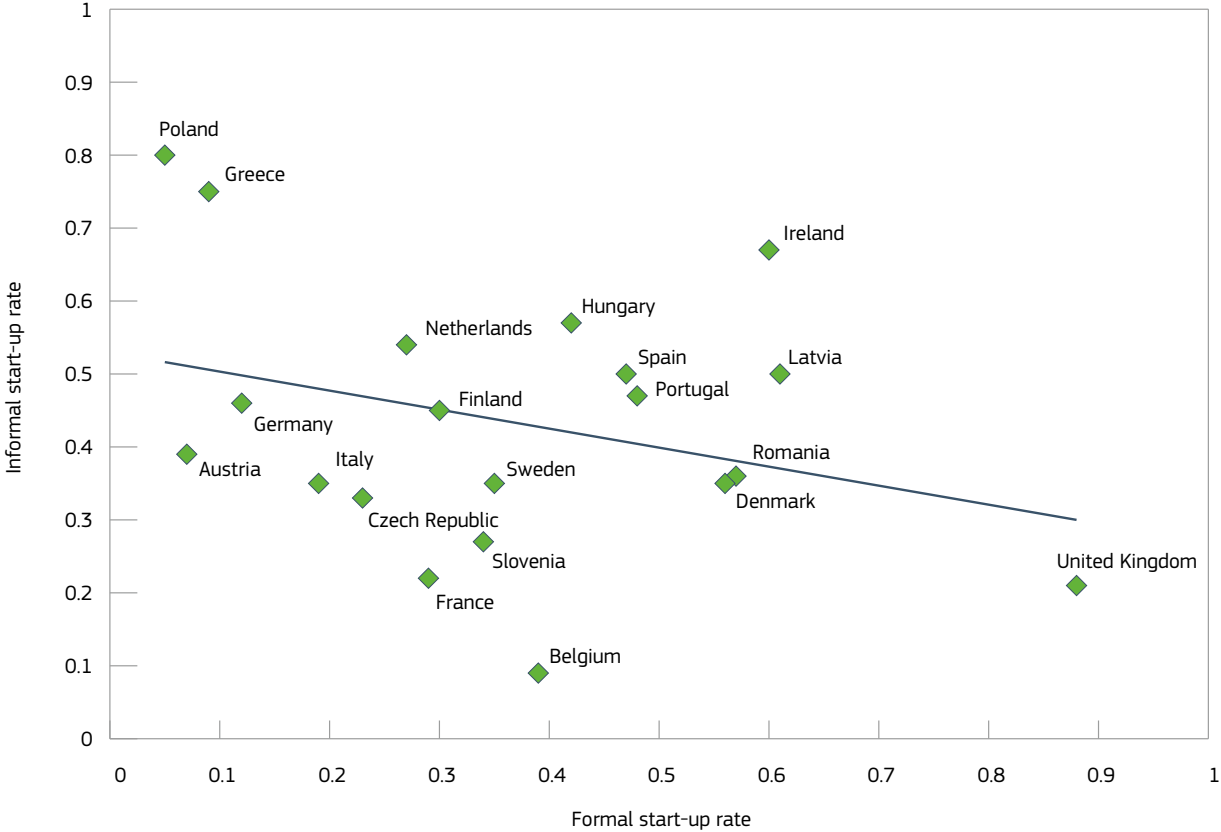
Source: OECD based on Autio E. and K. Fu (2014), "Economic and political institutions and entry into formal and informal entrepreneurship", *Asia Pacific Journal of Management*, published online 13 May 2014.

<sup>(5)</sup> In this study, formal start-up rates are based on the World Bank Entrepreneurship Survey Dataset and correspond to the proportion of people starting a business in the working age population (18-64). Informal start-up rates, on the other hand, are estimated through an econometric model where the total start-up rate derives from the GEM definition of new entrepreneur (i.e. any individual whose business has paid salaries to any person for longer than 3 months but less than 42 months) and the informal start-up rates is the simple difference between such total estimate and the WB-based formal start-up rate.

More generally, there is a negative correlation between formal and informal start-up rates: the higher the informal start-up rate, the lower the formal start-up rate (Fig. 3). This points to a substitution effect in the entrepreneur's choice between

whether or not to register his/her business, a choice which is affected by economic and institutional conditions that policy can influence.

**Figure 3. The relationship between informal and formal start-up rates**  
 Number of new businesses per 100 adult-age population



Source: OECD based on Autio E. and K. Fu (2014), "Economic and political institutions and entry into formal and informal entrepreneurship", Asia Pacific Journal of Management, published online 13 May 2014.

## ■ THE MAIN CAUSES OF INFORMAL ENTREPRENEURSHIP

The size of informal entrepreneurship is affected by a host of economic, institutional and social factors whose importance depends on the development stage of the country. In this section, the focus is on the main drivers of informal entrepreneurship in an economically advanced context such as the EU. A distinction between economic and institutional causes is advanced.

### Economic and demographic causes

*Macroeconomic conditions:* The decision to work in the informal sector is influenced by macroeconomic conditions, as higher GDP per capita levels are linked to lower informality rates. Table 1, for example, shows that the EU countries with the five largest informal sectors are from Eastern Europe (Bulgaria, Romania, Lithuania, Latvia and Estonia), where income per capita is below the EU average, whereas those with the five smallest informal sectors have all above-average GDP per capita (Austria, Luxembourg, the Netherlands, United Kingdom and France). The relationship between macroeconomic conditions and informal entrepreneurship goes in the same direction, as it has been observed that informal start-up rates are the highest in two less well-off EU countries such as Poland and Greece.

*Labour market conditions:* Labour market conditions are linked to macroeconomic conditions, but also depend on labour market institutions such as national employment protection legislation. Since entrepreneurship is ultimately an employment choice, labour market conditions will influence the decision of whether and how to start a business. Thus, strong job protection will discourage entrepreneurs from formalising their business and hiring workers regularly, whereas high unemployment and low labour market participation will cause higher numbers of informal necessity-driven self-employed workers. Lagging regions of the EU are a case in point of where high unemployment and low participation coexist with large swathes of informal self-employment, especially in certain segments of the population such as women (Meldolesi and Marchese, 2005). In the empirical literature, a strong correlation between slack labour markets and economic informality is typically found (Schneider et al., 2010; Renooy and Williams, 2014).

*Macroeconomic trends:* Variations in economic growth and unemployment also have repercussions on informal entrepreneurship. Recessions will prod more entrepreneurs into the underground economy to cope with declining revenues, whereas periods of economic expansion will reduce the incentive for entrepreneurs to remain informal by generating new opportunities in the formal sector.

*Industry structure:* Services and construction are more prone than manufacturing to informal self-employment, so that countries with a large services sector or a booming construction industry will tend to show higher rates of informal entrepreneurship. A

large part of this informal economic activity is undertaken by social groups that are disadvantaged in the labour market, such as women in household services or migrants and ethnic minorities in home maintenance and construction.

*Ethnic minorities and immigrants:* Countries with large shares of immigrants and ethnic minorities in the population tend to have more informal entrepreneurship. New immigrants may not have the legal rights to live and work in the host country, which will force them into undeclared work and informal self-employment. Cultural barriers may also prevent migrant or ethnic-minority entrepreneurs, especially women, from operating in the formal sector. Finally, some ethnic minorities show stronger propensity than others to self-employment, part of which is run informally. In the United Kingdom, for example, the self-employment rate among the Chinese and Pakistanis is around 20%, compared with 12-13% among Bangladeshis and Indians, and 6-7% among the Black African and Caribbean population (Basu, 2006).<sup>(6)</sup> Informal ethnic minority entrepreneurship has been widely researched, examples being Chinese entrepreneurs in Italy's industrial districts and Turk entrepreneurs in Germany (Dei Ottati, 2013; Constant et al., 2003).

### Institutional causes

*Taxation:* Taxation affects informal entrepreneurship in multiple ways. However, to the extent that most new starts-ups and self-employed businesses are unincorporated and are thus not subject to corporate taxation, the personal income tax rate will be the main tax-related factor influencing the choice of the entrepreneur of how much to declare of his/her revenues. High taxes on labour income are also thought to increase informal self-employment because the self-employed more easily than wage workers can hide part of their revenues to tax authorities or convert private consumption into tax deductible business costs (Henrekson and Johansson, 2009). From the demand-side, high personal income taxation may deter the market provision of low-skilled services (e.g. personal caring, cleaning, etc.) which can be easily generated at home or sourced in the informal sector. The way the tax system is designed also matters. Regressive tax systems with few marginal tax rates will have a bigger dent on diminishing revenues, thus spurring more entrepreneurs to go informal especially in the low-income brackets of the population.

*Business regulations:* Compliance with business rules and regulations implies cost and time, which are proportionally bigger for own-account workers and new entrepreneurs still waiting for the first revenues to flow in. A great deal of research corroborates the negative influence of high taxation and burdensome business regulations on the informal sector, especially in

<sup>(6)</sup> The self-employment rate is given by the share of the employed population who is self-employed. In the case of ethnic minority groups, thus, the self-employment rate is the percentage of self-employed out of the total employed population for the specific group.

high-income countries whose economies are more regulated (Schneider et al., 2010). A more recent stream of work, however, counters this prevailing view and posits that this relation is less solid than commonly believed (Renooy and Williams, 2014).

*Social security systems:* National social security systems often contain disincentives to formal entrepreneurship. For example, the self-employed are required to pay in full for the social contributions of their pensions, which are not as generous as those of wage workers. Altogether, this increases the attractiveness of informal entrepreneurship compared to formal entrepreneurship. Similarly, welfare recipients (e.g. the unemployed or the disabled) may show a preference for informal entrepreneurship out of the fear of losing existing entitlements, while senior people who consider moving from employment to self-employment may be discouraged to do so in the formal sector due to the frequent separation between the worker and employer pension systems. Empirical evidence confirms that extensive social security systems may have an impact on formal entrepreneurial activity (Hessels et al., 2007), and that this impact is likely to be more pronounced in social groups that more actively benefit

from this system (e.g. the unemployed, the disabled, women, etc.) (OECD/EC, 2014).

*Lack of deterrence:* A loose government approach to contrasting the informal economy tends to lead to higher rates of informal entrepreneurship (Tanzi, 1982). By the same token, inconsistent enforcement and corruption will also provide an incentive to conceal activities in the informal sector (Singh et al., 2012). However, another stream of research argues that deterrence that is too severe will not lead to more compliance but rather deteriorate the trust relationship between the state and citizens (Murphy, 2008).

*Tax morale:* Tax morale refers to the perceived fairness of the tax system. Respectful and impartial tax authorities who apply reasonable rates and inform taxpayers on how public money is spent are associated with improved tax compliance (Williams, 2014). Empirical studies underpin the importance of an appropriate tax system to curb tax evasion, especially the perceived fairness of the tax system and the attitudes of taxpayers towards the government (Tanzi, 1982).

## ■ THE IMPACT OF INFORMAL ENTREPRENEURSHIP IN THE ECONOMY

The effects of informal entrepreneurship on the economy are mixed, since informal businesses can be a source of unfair competition towards the formal sector as much as one of livelihood for the unemployed. However, it is generally accepted that disadvantages outweigh advantages in advanced economies, which provides the rationale for the formalisation strategies that the European Commission and EU national governments actively pursue. This section outlines the negative and positive consequences of informal entrepreneurship for each of the main actors directly or indirectly concerned by it.

### Informal entrepreneurs

Informal entrepreneurs are those who gain the most of the underground activity they undertake. They make extra profits through tax evasion and lower start-up costs and take advantage of more flexible work arrangements. Some of these advantages are especially important to socially disadvantaged groups. Lower start-up costs will be most appreciated by cash-constrained youth and the unemployed, whereas flexibility will mostly benefit women who need to combine work and family and the physically disabled who may have a preference for a home-based business.

However, there are disadvantages for informal entrepreneurs as well. First, they will be less likely to grow beyond a certain

threshold, since they cannot ask for bank loans, participate in public tenders or submit applications to public programmes. Second, future formalisation can turn out costly, if the entrepreneur is required to pay for past tax and social security obligations, or difficult if she/he has to demonstrate a certain number of years of experience in the trade. Third, informal entrepreneurs have few legal means to resort to in the event of late or partial payment, which can prove especially harmful for those who already have little familiarity with the workings of the legal system (e.g. migrants and low-educated).

### Formal entrepreneurs

Formal entrepreneurs are mainly damaged by the unfair competition of informal entrepreneurs, which can unleash “a race to the bottom” where more entrepreneurs go informal to survive. This will particularly apply to formal entrepreneurs from disadvantaged groups engaged in low value-added activities more exposed to price competition. At the same time, it is often argued that formal entrepreneurs may also benefit from informal entrepreneurship if they contract out part of their production to informal self-employed workers. Many studies have confirmed that formal and informal sectors are more intertwined than commonly thought, and that linkages between formal and informal businesses are frequent (Portes et al., 1989).

## Customers

The main reason for customers to resort to informal entrepreneurs consists in more affordable products and services. The main risk is that little is known about the health and safety conditions under which production has taken place and that, in case of unsatisfactory work, there is no warranty on which to fall back.

## Governments

Governments clearly lose out of informal entrepreneurship. First, tax evasion shrinks government revenues and saps the government ability to undertake economic development and social policies, which will particularly penalise those socially

disadvantaged groups more likely to be involved in the informal sector. Second, high informal entrepreneurship rates entail a loss of control by the government on working conditions and quality of services provision. Finally, large swathes of informality may engender a culture of illegality in the wider society.

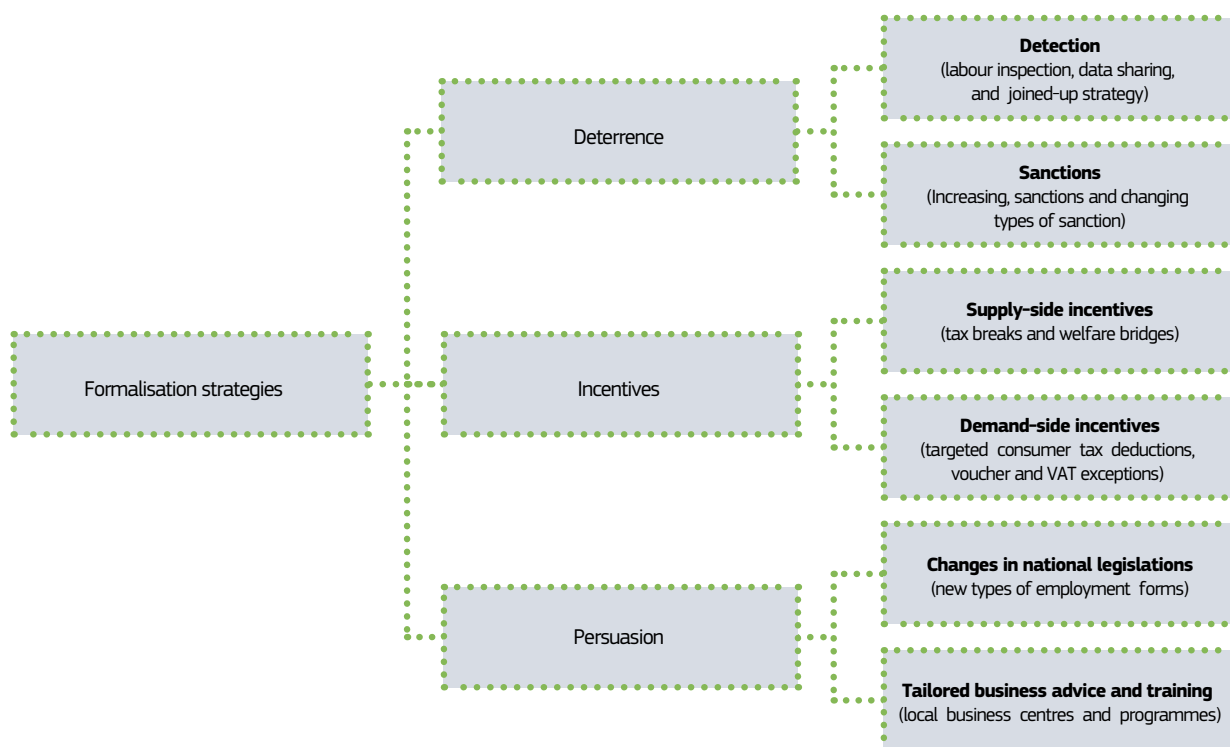
At the same time, most governments acknowledge that informal entrepreneurship can be a stepping stone to formal entrepreneurship, i.e. that many entrepreneurs who start in the informal sector will later regularise their business. As a result, using the “iron fist” over informal entrepreneurs is hardly ever considered the only policy option and, in most cases, deterrence is combined with other measures which encourage business regularisation.

## ■ A CONCEPTUAL FRAMEWORK FOR FORMALISATION STRATEGIES

In this section a distinction is made between deterrence (i.e. sticks), incentives (i.e. carrots) and persuasion measures available to EU governments to formalise informal entrepreneurship. The first two approaches stem from the assumption that entrepreneurs are rational actors who turn to the informal economy when perceived benefits are higher than expected

costs. Thus, they seek to change the cost-benefit ratio by either raising the likelihood of detection and cost of sanction (deterrence) or by increasing the benefits of working in the formal sector (incentives). Persuasion measures moves away from this cost-benefit logic to foster a behavioural change through an improved relationship between the state and entrepreneurs.

Figure 4. A conceptual framework for formalisation strategies



Source: OECD based on Williams (2014)

The focus of European formalisation strategies has traditionally been on undeclared work as a whole, rather than on narrowly-defined informal entrepreneurship. In 2003 the European Commission released the Employment Guideline “Transforming Undeclared Work into Regular Employment” (EC, 2003), which encouraged Member States to fight undeclared work through a broad set of actions, from the simplification of the business environment (persuasion), to an overhaul of disincentives and incentives in the tax and social security systems

## ■ DETERRENCE

Deterrence is a cornerstone of formalisation strategies across EU Member States. However, deterrence alone is unlikely to succeed in the formalisation of informal entrepreneurship for a number of reasons. First, inspections are better suited to spotting undeclared wage employment (e.g. wage envelopes) than informal self-employment. Second, penalties that are too harsh or labour inspections that are too frequent can break the trust relationship between the state and the entrepreneur, who may be induced to move his business further underground rather than to formalise it. Third, if sanctions are too severe they may drive sanctioned entrepreneurs out of the market, thus destroying jobs and making the people that the sanctions were to protect more vulnerable. Finally, the heavier the penalties or the bigger the prerogatives of state inspectors, the stronger the risk of corruption where entrepreneurs and government officers settle disputes through “under-the-table” arrangements. Thus, deterrence can but be one component of a broader formalisation strategy.

Deterrence measures in EU countries have generally included labour inspections, sanctions and co-ordinated government strategies.

### Labour inspections

Labour inspections are utilised by all EU Member States to combat undeclared work (Williams et al., 2013).<sup>(7)</sup> However, due to their nature, they are more likely to find undeclared work (e.g. wage envelopes and non-payment of social security contributions) than informal entrepreneurship. One reason is that most labour inspections originate from complaints of workers against employers, which exclude informal self-employed and new entrepreneurs. Moreover, even when labour inspections are pro-active, they target registered companies whose information provided to government authorities is inconsistent; thus, they miss out fully informal entrepreneurs. Finally, because labour inspectors do not have the right to enter private homes, they do not cover sectors such as personal and household services where informal entrepreneurship is common. In spite of these

(7) Less common has been a demand-side approach where customers are asked to keep and show on request receipts of work done in sectors where informal activities are common (e.g. construction, home repairing, personal caring, etc.).

(incentives), to better law enforcement (deterrence). In 2007, the second Communication by the European Commission on the topic, “Stepping up the Fight against Undeclared Work”, further stressed the role of tax morality (persuasion) to formalise undeclared work (EC, 2007b). EU Member States implement each element of this policy portfolio, although persuasion and incentive measures are more common to Northern and Western Europe, while Eastern European countries are more tilted to deterrence (Williams et al., 2013).

drawbacks, labour inspections should still be part of formalisation strategies aimed at informal entrepreneurship since they can detect the self-employed who are only partly informal.

Labour inspections in EU countries have aimed at sectors where undeclared work is known to be rife. So, in Romania they have primarily vetted the construction, clothing and textile sectors, in Latvia and Portugal hotels and restaurants, while in Sweden taxis, hairdresser and restaurants (ILO, 2010). While this mapping is not comprehensive, it confirms that labour inspectorates concentrate on sectors where irregular wage employment is most common, although construction, hairdressing and even taxis may all contain instances of informal self-employment.

Policy actions have included the training of labour inspectors, who have increasingly been asked to change their role from simple law enforcers to trainers and educators who help business owners to comply with the law. As part of this reform, many labour inspectorates have introduced “early warnings” by which a deadline to abide by the law is given before a penalty is handed out.

A parallel development has involved streamlining the functions of labour inspectorates, which have been urged to focus on detection, sanctions and education (ILO, 2010). In the future, this re-organisation of tasks might help labour inspectorates to better target informal entrepreneurship, although this is likely to require a more important role of education over sanctions to avoid discouraging new entrepreneurs willing to regularise their position.

### Sanctions

Penalties in EU Member States are proportional to the size of the business and the gravity of the infraction. Therefore, they are generally small for informal self-employed and new entrepreneurs from socially disadvantaged groups. Nonetheless, there has been a general tendency in Europe to tighten up penalties and increase fines during the last years (ILO, 2010). For example, in France sanctions for those who hire workers irregularly can reach up to EUR 45 000 and up to five years of inhibition from running a business in the same sector. In Austria, in 2007, the maximum fine for unregistered workers increased from EUR 3 600 to EUR 5 000 for each single case. Slovakia,

on the other hand, toughened sanctions both for companies hiring illegal workers and for businesses that do not register. In the latter case, the fine was raised to SKK 500 000 (approx. EUR 17 000).

Sanctions have also taken more innovative forms, such as the prohibition for labour law or business law offenders to apply for public support programmes or “naming and shaming” initiatives where the names of offenders have been made public. Prohibitions from public subsidies are particularly important to tackle informal self-employment, since self-employed people are common targets of public support programmes and tax breaks due to low revenues, while “naming and shaming” can effectively discourage those who see informal entrepreneurship as only a temporary phase.

## Data sharing and joined-up strategies

Undeclared work crosses the responsibilities of different ministries, making data sharing and policy co-ordination necessary. For example, tackling informal entrepreneurship by illegal immigrants will require collaboration between immigration

bureaus and labour inspectorates. If detection is to be coupled with incentives, labour inspectorates will also have to collaborate with ministries of finance for tax breaks and ministries of economic development for participation in active support programmes (e.g. business advice and training).

There are ample examples of inter-ministerial collaboration in the EU. In Poland, labour inspectorates have access to information about tax payment, social insurance and citizen identification which are all held by different government administrations. Belgium introduced in 2009 an international migration information system, called LIMOSA, to monitor possible illicit behaviours of immigrants working at below-market wages. In France, the Inter-Ministerial Delegation to Combat Illegal Work (Délégation interministérielle pour la lutte contre le travail illégal – DILTI) pursued between the mid-1990s and mid-2000s a highly co-ordinated approach, both at the national and local levels, to combat undeclared work. In Italy, the National Committee for the Regularisation of Undeclared Work (i.e. Comitato per l'emersione del lavoro non regolare) was established in 1998 in the Prime Minister's Office to co-ordinate all formalisation policies in the country, including incentives (e.g. the law 383/2001, Box 1) and awareness-raising campaigns.

## ■ INCENTIVES

Monetary and fiscal incentives aim to increase the convenience for entrepreneurs to work in the formal sector. In order to tackle informal entrepreneurship, incentives are more important than deterrence for three main reasons. First, as already noted, labour inspections find it difficult to detect the informal self-employed, especially when they work from home, and new entrepreneurs whose business is not registered. Second, “informal entrepreneurship” does not involve exploitative labour relations; this reduces its social harm to tax evasion and unfair competition, both of which are more “reformable” than unacceptable labour practices. Third, many informal entrepreneurs will want to formalise after a testing period meant to develop an initial client base; stamping out this type of informal entrepreneurship only through deterrence will produce the unintended effect of discouraging the “entrepreneurial spirit” which governments otherwise try to promote. For example, a study in Ukraine found that 28% of the 600 surveyed entrepreneurs operated without any business registration, but that one-third of them was planning to amend their status soon (Williams and Nadin, 2014).

Incentives for informal entrepreneurship may act on both the supply and demand sides. Supply-side incentives will make easier for the self-employed and new entrepreneurs to engage in compliant behaviour. Some of the most common are tax breaks and welfare bridges. Demand-side incentives will try to persuade consumers to source products and services in the formal sector. They are often sector-based and include tax deductions, vouchers and VAT exceptions.

## Supply-side tax breaks

Tax breaks on personal income and concessions on social security contributions are commonly used ways to ease the transition from the informal to the formal sector; for example, women's and youth entrepreneurship programmes often integrate fiscal incentives of this type.

The upside of tax breaks is that they provide a clear monetary benefit to stay in the formal sector, although lowered social contributions may dim the pension prospects of entrepreneurs. The downside is that supply-side tax breaks are generally temporary to avert excessive market distortions, which may discourage participation if informal entrepreneurs perceive the future costs of compliance (i.e. full payment of taxes and full exposure to inspections) higher than any tax-related benefit. Another common criticism is that targeted tax breaks may cause “displacement effects” by which supported entrepreneurs crowd out those who do not receive support. This is most likely to happen if the targeted entrepreneurs set out businesses in traditional activities (e.g. retailing) and deprived areas (e.g. peripheral urban neighbourhoods) where competition is driven by prices.

Italy's law 383/2001 offers a good example of tax breaks directly aimed at informal entrepreneurs. It is also a case in point of the limits of pro-tempore fiscal measures.



### Box 1. Italy's 383/2001 Law

**Target group:** Fully or partly informal entrepreneurs evading taxes and the payment of social security contributions.

**Objectives:** Help informal entrepreneurs to gradually move to the formal sector during a grace period of three years.

**Intervention type:** Temporary tax breaks for entrepreneurs willing to regularise their position.

**Duration:** The law was in place between 2001 and 2003; the last regularisation processes were terminated in 2005.

**Description:** The law was an attempt by the Italian government to curb informal self-employment and undeclared work through traditional tax breaks directed at partly informal entrepreneurs. In its original design, the measure did not cater for entrepreneurs whose business was not registered.

Informal entrepreneurs who decided to declare income that was previously undeclared were given the opportunity to retroactively pay the tax owed at a concessional marginal tax rate of only 10% in the first year, 15% in the second year, and 20% in the third year. Social contributions owed by entrepreneurs for previously undeclared workers were also lowered to 8%, 10% and 12% over the three-year period of the regularisation process. For their part, involved workers received favourable income tax rates on their newly declared income to make sure that they would also benefit from formalisation; in this case, the applied rates were 6%, 8% and 10%. A general amnesty from unpaid taxes and social contributions for the past was also part of the support package.

The law went through two major amendments. The first set up special rules for home-based own-account workers, whereas the second created a parallel "staged" procedure where companies would have to submit a "regularisation plan" and have it approved by local government committees before they could benefit from tax incentives.

**Results achieved:** By the end of 2002, the first and most successful year of the law, 800 applications involving the regularisation of 1 500 workers had been submitted through the automatic procedure. This was a result below the government's expectations whose main cause was a high degree of uncertainty associated with the measure.

First of all, temporary tax breaks did not convince many informal entrepreneurs to make the leap towards the formal sector. In a study covering the province of Naples, informal entrepreneurs reported concerns that they would not be able to survive after the initial three-year subsidised period, that they would be asked one day to pay for previous tax irregularities (in spite of the amnesty), and that they would become the target of labour inspections in the future (Bàculo, 2004). In a weak economic context such as Italy's south, a tax break policy was thwarted by the lack of trust towards the state by its citizens. Additional uncertainty was added by the introduction of an alternative "staged" procedure, which proved complex and whose final costs would not be clear until the approval of the plan, and by the frequent postponement of the deadline to apply for the measure, which reduced the perceived importance of the law.

**Lessons learned:** i) tax breaks are a powerful tool, but in economically weak contexts they need to be part of a broader package – for example, advice and training – to address multiple forms of disadvantage; ii) tax breaks should be certain, last for a reasonable period of time, and not be withdrawn without notice if they are to have an impact on the cost-benefit considerations of informal entrepreneurs; iii) if combined with amnesties, a government certificate testifying that the entrepreneur cannot be persecuted for irregularities condoned by the amnesty can help win the confidence of future participants.

Source : Bàculo (2004)

## Welfare bridges

Part of informal entrepreneurship is carried out by welfare recipients – primarily, the unemployed and the retired – afraid of losing their entitlements if they were to declare an income-generating activity. This fear is reinforced by frequent lack of clarity in national welfare systems about the possibility for welfare recipients to undertake work activities in parallel.

A major incentive for welfare recipients to declare a self-employment activity is therefore to keep their benefits, in part or in full, as they set out a business. These measures are known as "welfare bridges" and are primarily aimed at the unemployed, although they can in principle target other groups such as the retired and the disabled. In this case, however, welfare

bridges would have to be permanent rather than temporary, as for the unemployed.

Welfare bridges are typically of three types. In the first most common type, participants continue to receive their entitlements for a period that can go from a few months to a couple of years while they start a new income-generating activity. This approach is used in Germany, Ireland, United Kingdom, Denmark and Sweden. In the second type, a lump-sum is given which covers the full amount of entitlements that the recipient would have had the right to receive during his spell in the welfare system. This approach is more typical of southern Europe (e.g. Italy, Spain and Portugal). A third and final approach consists in giving an equal (small) start-up grant to participants regardless of the benefits which they receive. This policy is more common

to some Eastern European countries such as Croatia, Czech Republic, Slovakia and Hungary (OECD/EC, 2014).

In addition to tackling informal entrepreneurship, welfare bridges buttress labour market participation and lower pressure on government budgets through reduced expenditures (in the case of the unemployed whose benefits are progressively

phased out) and increased tax revenues. Nonetheless, fiscal incentives need to be combined with advice and training to convince people who have been long away from the labour market to become entrepreneurs. As a result, welfare bridges are often part of wider programmes where participants receive other forms of non-monetary support. The Test-Trading scheme in the United Kingdom is an example.

## Box 2. The UK Test-Trading Scheme

**Target group:** Unemployed people with at least 18 months of continuous unemployment benefit claims (for the unemployed aged between 18 and 24, the requirement was lowered to 6 months).

**Objectives:** Provide a self-employment route out of unemployment to the long-term unemployed.

**Intervention type:** Welfare bridge combined with business coaching and mentoring.

**Duration:** The programme is in place since 1998. Participation consists of up to 9 weeks of preparation to which 26 weeks of trade-testing period are added. In total, therefore, the programme lasts 8-9 months.

**Description:** Three stages comprise this initiative. In the first stage of one day participants explore possible business ideas with mentors. In the second stage, participants undergo a one-day weekly training for up to 8 weeks, which leads to the formulation of a business plan. In the third stage, participants test their business for up to 26 weeks, in which period they continue to receive an allowance corresponding to the previous welfare entitlement together with a grant of up to GBP 400 (approx. EUR 550). Money earned during the test-trading period is not taxable and is either re-invested in the business or saved into a special bank account of the government department managing the scheme (i.e. the Department of Work and Pension).

During the test-trading period, participants also go through training sessions geared towards a formal qualification and receive continuous mentorship by programme managers. The mentoring does not stop after the 26 weeks of test-trading, but can continue for up to 2 years when the business is formally established and operational.

**Results achieved:** The take-up of the scheme has been much higher in the older cohorts of long-term unemployed than in the younger cohorts. In particular, it has been 9.4% among the long-term unemployed aged above 50, 4.6% in the 25-50 age cohort, and only 1.6% among those aged between 18 and 24. Participation has also been higher in the white, male and higher-educated long-term unemployed living in more affluent areas, while certain groups such as ethnic minorities have showed little participation.

The only evaluation of the intervention was done in Northern Ireland and demonstrated that 87% of participants entered the test-trading period after completion of stages 1 and 2, while 62% were still in self-employment 13 weeks after the end of the test-trading period.

Programme managers highlighted three major areas of improvement. First, eligibility criteria could have been extended to all unemployed people regardless of the duration of the unemployment spell. Second, the test-trading period could have been made longer, as 26 weeks seemed too short to learn how to run a business after a long period of inactivity. Third, such an extended programme would however have only been possible if benefits had progressively been phased out.

**Lessons learned:** i) welfare bridges need to be part of broader packages combining advice and training to help welfare recipients to overcome multiple barriers (e.g. lack of skills and networks) to labour market participation and business creation; ii) welfare bridges are more likely to work for certain target groups (e.g. seniors and short-term unemployed) than for others (e.g. youth and ethnic minorities); iii) if welfare bridge initiatives are to cover hard-to-reach groups, they may require a bespoke approach where, for example, ethnic minorities are mentored by community-based organisations; iv) eligibility criteria should be wide enough to ensure adequate take-up and lower administrative overheads; v) welfare bridges need to be designed carefully – for example, with respect to duration and entitlements – to appeal to welfare recipients without generating situations of “moral hazard”.

*Source:* Eurofound's website (<http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/uk007.htm>)

## Targeted consumer tax deductions and vouchers

Demand-side incentives increase the convenience for consumers to source products and services from formal entrepreneurs. They are often targeted to sectors where informal entrepreneurship flourishes, such as personal and household services (e.g. home repairing and maintenance, cleaning and gardening, childcare and elderly care, etc.) or construction. For example, the European Commission acknowledges that without public support formal employment in personal and household services is costly for the majority of the population and that this leads to high rates of undeclared work in this sector. In Germany, there are an estimated 600 000 informal domestic workers, while in Italy the same estimate points to between 700 000 and 1.1 million (EC, 2012); a very large majority of informal domestic workers work on their own.

Governments can favour formal entrepreneurship in these sectors in different ways, two of which are the granting of income tax deductions on the costs incurred to obtain these services legally and the issue of vouchers by which consumers only pay a fraction of the hourly wage rate, leaving the remaining part to be covered by the state. In the first case a tax relief is claimed on the annual income tax declaration, while in the second case the voucher price integrates a state wage subsidy.

Tax deductions and vouchers are easy to implement and purvey a clear financial incentive to consumers to contract work in the formal sector. However, they are more likely to transform informal self-employment into formal wage employment, rather than formal entrepreneurship, if they favour the supply of services from larger certified companies, as done by some voucher programmes (see, for example, Box 4).

In addition, there are some cautions to bear in mind when policy makers introduce similar policies. Firstly, the smaller is the incentive, the higher is the risk for the policy to subsidise work that would have taken place in the formal sector anyway. On the other hand, a larger subsidy requires a bigger financial commitment by the government. Secondly, there is a risk that the subsidy is seized by the supplier of work through an increase in the price of the service to the extent that rational suppliers will be aware that part of the service costs is met by the state. In the long run, this may lead to price inflation in the sectors targeted by the policy. Thirdly, for illegal migrants who cannot join the scheme, a voucher policy may have the perverse effect of pushing further down their wages to be able to compete with those who can use the vouchers.

Tax deductions for home repairing in Denmark (Box 3) and vouchers for personal care services in Belgium (Box 4) are two typical examples of the policies described in this section.

### Box 3. Denmark's Home-Job Plan

**Target Group:** Consumers of personal and household services in the sectors of cleaning, indoor and outdoor house maintenance, gardening and babysitting.

**Objectives:** To reduce the supply of informal entrepreneurship in the targeted sectors, but also more generally to create new jobs in construction and encourage the installation of environmental-friendly solutions in Danish households.

**Intervention type:** Tax deductions of 15 % for each household member and up to a threshold of DKK 15 000 (approx. EUR 2 000) per person per year on the costs incurred to buy the targeted services.

**Duration:** Pilot project from June 2011 to the end of 2013.

**Description:** Home-job plan was established in 2011 as a three year pilot project budgeted with DKK 1 billion (EUR 134 million) in 2011 and DKK 1.75 billion (EUR 234 million) in 2012 and 2013. The operational rules have been very simple. The buyer of the service declares the name of the service provider, the number of hours acquired and the costs incurred to tax authorities, which will then deduct such costs from the annual taxable income. In more than 95 % of cases the form was filled online, which pushed the tax authority to define this measure a breakthrough for digital communication between the state and its citizens.

**Results achieved:** This tax deduction has been widely used and its resources have quickly run out each year. For the year 2011, some 270 000 people used the tax incentive, mostly for a sector such as house maintenance and repairing where informal self-employment is diffused. The average reported cost for tax deduction was DKK 9 800 (EUR 1 315), while total deductions amounted to DKK 2.7 billion (EUR 362 million). The measure was deemed useful both by consumers and construction business associations. The only criticism concerned the ceiling of deductible costs (EUR 2 000), which was considered low compared with other similar interventions (e.g. EUR 6 600 in Sweden).

**Lessons learned:** i) Small deductions programme need to be simple in their administration to attract users and reduces overheads; ii) an online administration of the programme is generally suggested, although the risk is that it may exclude the low-educated and senior population; iii) tax deductions are better targeted to sectors where informal self-employment is known to be high; iv) the additionality of the measure as well as the capture of the benefit by suppliers is a potential problem that policy makers need to monitor.

Source : Eurofound's website (<http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/dk015.htm>)

#### Box 4. Belgium's personal caring voucher scheme

**Target group:** Customers of personal and household services and companies in these sectors willing to hire unemployed people likely to resort to informal self-employment otherwise. The eligible sectors were housecleaning, meal preparation and transport of people with mobility problems.

**Objectives:** To reduce informal self-employment in the targeted sectors by giving an incentive to customers to purchase services from registered companies, to incentivise registered companies to hire unemployed people, and to offer certain categories of unemployed the opportunity to move from irregular self-employment to a regular employee status.

**Intervention type:** A voucher integrating a wage cost subsidy to exchange with the supplier of a household service.

**Duration:** In place since January 2004.

**Description:** Each consumer wanting to buy personal services in the eligible sectors can purchase up to 500 vouchers, the first 400 of which at the price of EUR 9 while the remaining 100 at the price of EUR 10 (families can claim to 1 000 vouchers yearly). Each voucher pays for one hour of work, whose hourly full cost is of EUR 22. The difference between the voucher price and the hourly wage cost is subsidised by the government. Moreover, up to EUR 1 350 of the costs incurred by consumers per year are tax deductible. The net costs per employee amounted to EUR 3 520.

The vouchers can only be used by registered and certified companies which have hired unemployed people. The first employment contract can be fixed-term, but after six months it has to be converted into an open-end contract either full- or part-time.

**Results achieved:** In a recent evaluation of the measure, 25 % of the voucher consumers admitted that they would have resorted to informal workers without the voucher scheme, although less than 5 % of the workers being employed through vouchers avowed to having worked in the informal sector before. The measure seems to have especially benefited vulnerable groups. Low-educated women are the overwhelming majority of the voucher workers (97 %), while the share of non-Belgian nationals is significant (30 %) and includes a sizeable proportion of non-EU workers (one-third of the total).

By the end of 2011, nearly 110 million vouchers had been issued, 830 000 customers had used the vouchers and nearly 3 000 companies had been involved. It is estimated that approximately 150 000 people have been employed through the voucher programme.

**Lessons learned:** i) voucher schemes can make a dent on informal self-employment in personal services but they will mainly encourage the transformation of the informal self-employed into formal wage workers if they favour established certified companies; ii) the price of the voucher needs to be set at a low level, close to the hourly wage rate in the informal sector, to appeal customers; iii) strong subsidisation is therefore needed, which is likely to limit the scope of the measure in the presence of government budget constraints; iv) similar voucher schemes may not work where there is not a tradition of externalising personal and household services in the market.

*Source :* Williams (2014)

## VAT exceptions

Another demand-side policy consists in encouraging formal entrepreneurship through value-added tax (VAT) deductions in sectors where informality is widespread. This policy has been common to many EU Member States (e.g. France and Italy) and rests on the assumption that lower taxation will boost tax morality. Its main advantage lies in its simplicity and long-term duration, both of which are more likely than temporary tax deductions and vouchers to spur a behavioural change.

At the same time, targeted VAT reductions feature some challenges. First of all, the cost of the policy will be higher and less predictable than for more narrowly-defined tax deductions and vouchers, for it will depend on consumption trends in the targeted sectors. Secondly, VAT being a flat tax rate, its reduction will have a regressive impact that will favour

high-income consumers more than low-income consumers. Thirdly, at the political level, cutting down the VAT rate in few sectors may resolve other interest groups to ask for a similar treatment, triggering a downward spiral that can weaken the government budget.

Alternatively some countries, rather than cutting down VAT, have resorted to a “reverse VAT system” where the tax is paid by the service buyer rather than by the service provider. For example, Sweden in 2007 and Finland in 2010 enforced a reverse VAT system in construction, an industry where undeclared work and informal self-employment are nestled in long subcontracting chains. In both cases, the company that is mainly responsible for a construction project pays all VAT charges to the Tax Authority, so that subcontractors do not charge the VAT in their invoices. The reverse VAT system only applies to the provision of services, whereas the purchase of material which the provision of service may require is excluded.

## ■ PERSUASION

Persuasion is the third and less frequently used element of formalisation strategies. The objective of these measures is not so much to change the cost-benefit ratio for entrepreneurs who work in the informal sector or for customers who source work in the informal sector, as to win their “hearts and minds” and thereby enable a culture of law compliance and tax morality. The rationale is that it is not just self-interest that underlies people’s behaviour, but also social customs and legal institutions.

Persuasion policies can take both a generic and specific slant. Examples of generic approaches are awareness-raising and tax education campaigns which address the wider society. The former will typically inform the population about the risks of working in or buying from the informal sector. The latter will tell citizens what the tax system requires of them and what happens to their taxes. A significant part of tax evasion is, indeed, unintentional, resulting from lack of knowledge or misunderstanding of the law (Williams, 2014; Natrah, 2013).

Many examples exist at the EU level. Bulgaria launched in 2007 a national campaign called “Come into the light” where employer associations, unions and media outlets, with the support of the government, came together to design initiatives that would raise awareness about the negative consequences of the informal economy. In addition to traditional awareness-raising initiatives, the programme also gave web users the opportunity to suggest ideas to deal with the informal economy and to complain about common labour law violations in the country.<sup>(8)</sup> Estonia launched in 2010 an information campaign more closely focused on tax compliance, with the main objectives of educating taxpayers on how their money is used and boosting tax morality in the population.<sup>(9)</sup>

Two more specific measures that, on the other hand, directly cater to informal entrepreneurs are changes in national legislations which create new job profiles and tailored advice and training programmes.

### Changes in national legislations

Changes in national legislations will buttress formal entrepreneurship through the legitimisation of jobs which would have otherwise probably occurred in the informal sector. They often imply simplification of rules and lower social security charges.

For example, France introduced in 2009 the new legal status of the “auto-entrepreneur” with a view to legalising small odd jobs often undertaken in the informal sector. The entrepreneurs

who choose this legal regime are exempted from business registration obligations and benefit from simplified administrative procedures and reduced social and fiscal contributions. This new job regime is estimated to have been mainly used by people in unemployment or underemployment, who have thus been given the opportunity to legitimise a business activity. Three-quarters of auto-entrepreneurs, indeed, report that they would not have started a business if there had not been this policy (OECD/EC, 2013); arguably, some of them might have started in the informal sector.

Changes in legislation may also be sector-specific. In 2008, Slovenia established a new register for childcare workers to tackle informal work in this area. The law provides that home-based childcare work can only be undertaken by people with at least secondary level education, complemented by specific vocational training, and with a clean criminal record. Enrolment in this special registry held by the Ministry of Education has become a prerequisite to register a childcare activity in the official business registry.<sup>(10)</sup>

### Tailored business advice and training

Tailored advice and training programmes aim to make informal entrepreneurs ready for the formal sector. These interventions recognise that the disadvantage experienced by informal entrepreneurs is not only of economic nature and that an incentive policy alone is unlikely to persuade informal entrepreneurs to come to light.

This is most likely to be true in economically deprived contexts and socially disadvantaged groups. In the first case, short-term incentives are unable to offset the long-term disadvantage of working in low-income regions or neighbourhoods where relationships between the state and local communities are also often strained. Advice programmes will therefore also serve the purpose of generating mutual trust between the state and informal entrepreneurs. This has been the rationale of the Urban Regeneration Centres “CUORE” in Naples, Italy, which have mentored informal entrepreneurs in some of the country’s most difficult neighbourhoods.

In the second case, tailored support programmes become a precondition for formalisation, since certain categories of entrepreneurs such as migrants and the low-educated may not have the skills or understanding of the legal system needed to start a formal business. This was the experience of “SPINNER” in Italy’s northern region of Emilia Romagna, which aimed at the regularisation of Chinese migrant entrepreneurs in the local textile industry.

<sup>(8)</sup> More information is available in the Eurofound’s website: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/bg003.htm>

<sup>(9)</sup> The information campaign was named “Unpaid Taxes Will Leave a Mark”. More information on this initiative is available in the Eurofound’s website: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/ee015.htm>

<sup>(10)</sup> By the end 2011, 149 childcare workers had registered. Further information is available on the Eurofound’s website: <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/si015.htm>

### Box 5. Two local approaches to tailored advice for informal entrepreneurs in Italy: CUORE and SPINNER

**Target group:** Informal entrepreneurs in economically disadvantaged neighbourhoods (CUORE) and Chinese migrant entrepreneurs in the textile sector (SPINNER)

**Objectives:** To favour the regularisation of informal entrepreneurs and the creation of new law-compliant businesses in the respective target groups.

**Intervention type:** Tailored business advice and training.

**Duration:** The CUORE centres were founded in 1999 and are still operating in four neighbourhoods of Naples; the SPINNER programme lasted from 2000 until 2006.

**Description:** The CUORE centres were established in four deprived neighbourhoods of Naples in 1999 with an initial budget of EUR 1.5 million from the local Municipality. The centres, which were the result of an agreement between the Municipality and the local university, originally focused on researching and monitoring informal business activities in the four targeted districts. Only later did they move to the provision of business development services to informal and aspiring entrepreneurs. Advice was both generic and tailored. Generic advice was on basic issues such as how to register a business, request a VAT number or still obtain a public health permit, whereas bespoke mentoring involved helping entrepreneurs to submit applications to public support programmes, participate in regional and national trade fairs and create business consortia to boost exports and the purchase of technology.

The SPINNER programme was a multi-partner initiative supported by the European Social Fund, the regional government of Emilia Romagna and the national Agency for Enterprise Development and Investment Attraction. The programme activities targeted the large community of Chinese entrepreneurs in Emilia Romagna's textile sector, many of whom engaged in low-skilled activities on the brink of informality (e.g. sewing). To do so, SPINNER hired cultural and linguistic facilitators with a view to building trust between the Chinese community and the state, delivering information about the business formalisation process, and facilitating the transition of informal business owners and the informal self-employed towards the formal sector. In this respect, SPINNER staff members also prepared formalisation plans that would detail the costs and opportunities related to the formalisation process and the different steps required of entrepreneurs to make their business law-compliant. The experience gathered in coaching informal entrepreneurs was finally translated into a handbook detailing different cases of informal entrepreneurship and pathways to business regularisation.

**Results achieved:** By 2009, CUORE had given start-up support to 3 600 nascent entrepreneurs, nearly half of whom were women. As many as 1 280 informal entrepreneurs received formalisation advice, with one-quarter of them successfully completing the transition to the formal sector (325 entrepreneurs). With a view to indirectly encouraging formalisation, cooperation among local entrepreneurs was also supported. Nearly 100 entrepreneurs collaborated in small-scale projects, including participation in regional and national fairs and the creation of a business consortium.

On the other hand, in its six years of duration (2000-2006), SPINNER established a contact with nearly 400 Chinese textile business owners corresponding to one-third of the total in the region of Emilia Romagna. Nearly half of them went through some form of training, primarily about the respect of health and safety conditions at work. Specialised mentoring was also offered on themes such as labour law legislation, taxation and urban planning. In 25 cases SPINNER designed highly tailored formalisation plans that would make explicit the different steps required to transform an informal business into a formal one.

**Lessons learned:** i) business advice and training are important means to foster business formalisation, but they require more time than direct fiscal incentives to achieve major results; ii) bespoke advice is more likely to prove useful than general training on law compliance; iii) the training of programme staff members is key to offering high-quality mentoring and coaching and thereby improve the reputation of the state among the targeted entrepreneurs; iv) hiring staff members from the same community of the targeted entrepreneurs will be important to win the confidence of participants.

*Source:* Eurofound's website (<http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/it001.htm>); <http://www.eurofound.europa.eu/areas/labourmarket/tackling/cases/it009.htm>); Bàculo (2004).

## ■ CONCLUSIONS

A large informal sector is a stumbling block to the development of advanced economies such as the EU's due to the unfair competition that it exerts towards the formal sector, the loss of state revenues that it implies, and the lax attitude towards legality that it can trigger in the wider society. Informal entrepreneurship is a major component of the informal sector, although the size of the phenomenon significantly varies in the EU, with higher rates in Southern and Eastern Europe. In the context of the EU, strategies to formalise informal entrepreneurship will be three-pronged and rest on deterrence, incentives, and persuasion.

Labour and tax inspections have been the most common form of deterrence but have primarily focused on the full respect of labour and fiscal norms by employers rather than on law compliance by the self-employed. There are different reasons for this, including the difficulty of detecting home-based activities and the tradition for inspection authorities to undertake visits mainly further to explicit complaints by workers. In the future, labour inspections may have to take a more proactive approach to cover informal entrepreneurship more extensively.

Although deterrence should be part of any formalisation strategies, fiscal incentives will play the most prominent role in reducing the size of informal entrepreneurship across EU countries. General tax reductions and pro-tempore tax breaks that directly target informal entrepreneurs are the measures most likely to abate the cost of formality. At the same time, especially in sectors where informal entrepreneurship is most common such as construction and personal and household services, sector-based tax deductions for customers will also contribute to reducing informal entrepreneurship.

Finally, emphasis has also been placed on persuasion measures such as awareness-raising campaigns, simplification of business regulations and business advice and training for informal entrepreneurs. These measures have the advantage of being relatively lower-cost compared with inspections and tax incentives and may prove important where informality also has cultural roots. However, on their own, they are unlikely to make a major dent in informal entrepreneurship.

To wrap up, the following recommendations are offered:

- Expand the scope of labour and tax inspections to better cover informal entrepreneurship. This may require a new balance between reactive and proactive inspections.
- Provide temporary tax breaks to facilitate the transition from the informal to the formal sector. At the same time, reduce general taxation, especially personal income tax, to make reductions in the size of informal entrepreneurship sustainable over time.
- Introduce sector-based tax deductions targeting customers in the sectors of the national economy where informal entrepreneurship is most common to decrease the attractiveness of informality from the demand side.
- Experiment with business coaching, mentoring and training tailored to informal entrepreneurs especially where informality has strong cultural roots.



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This policy brief was produced by the OECD and the European Commission. This policy brief focuses on the informal self-employed and informal entrepreneurs, which together comprise what we define as “informal entrepreneurship”. The policy brief provides estimates of the size of the informal economy and informal entrepreneurship in the EU, investigates its main causes and impacts on the economy, and finally presents a policy framework for formalisation strategies based on the distinction between deterrence, incentives and persuasion measures.

This policy brief is part of a series of documents produced by the OECD and the European Commission on inclusive entrepreneurship. The series includes policy briefs on youth entrepreneurship, senior entrepreneurship, social entrepreneurship, evaluation of inclusive entrepreneurship programmes, access to business start-up finance for inclusive entrepreneurship and entrepreneurship by the disabled as well as a report on ‘The Missing Entrepreneurs’. All these documents are available in English, French and German. They are available at <http://www.oecd.org/cfe/leed/inclusive-entrepreneurship.htm>

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